



# Mortgage Backed Securities

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## Abstract

The economic crash with its bailouts and bankruptcies, led to hundreds of thousands losing their jobs and homes. Time, tax cuts and other economic stimulus programs along with the experiment the Federal Reserve was trying to implement of a zero interest rate policy and bond-buying program has led to small increments of progress of economic recovery.

2008 was one of the worst times for mortgage backed securities because it was being compared to stocks as how risky they were if not more riskier than stocks. It became a domino effect all throughout the U.S. with more and more people defaulting on their loans. The U.S. became the land of foreclosures. With all of the foreclosures happening and nobody being able to buy these homes it was a nightmare for investors in these pools of mortgages.



## How Do They Work?

Investors usually purchase mortgage backed securities because they offer an attractive rate of return. Mortgage back securities provide a guaranteed return unlike stocks. The earnings are typically lower than investing in stocks over time but they are more secure. You are not playing the gambling game like with stocks, when you invest in a MBS everybody is a winner. This is why in times of economic uncertainty, more and more investors turn to this option and other security bonds as a safe investment when interest rates are low. When the economy recovers and investors are looking for a greater return, money is pulled out of mortgage backed securities and invested in stocks. This cycle repeats itself.

Before the loan can be sold it has to be created first which is called the primary market, where lenders make funds available to borrowers. It is the place where the loan application is taken, where the loan check comes from and where the payments made by the borrower to the lender are sent every month. The loan is then sold to the Government National Mortgage Association (Ginnie Mae) a U.S. government agency, or the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae), a U.S. government sponsored enterprises or an investment bank. Ginnie Mae, backed by the full faith of the U.S. government guarantees that investors receive timely payments. The agency pools together multiple loans that carry the same interest rates and then sells a low percentage of that pool to multiple investors. Doing this they lower the amount of money being paid which is more appealing in the eye of investors.

## History of the MBS

Prior to the first decade of the 21st century, it was routine for a U.S. bank to exercise an investigation into the applicant's history when considering lending money for a mortgage. Banks wanted to know all about an applicant's financial stability (income), debt, credit rating and they wanted it verified. This changed after the mortgage backed security (MBS) was introduced. Eventually the most desirable, qualified customers had homes so, banks turned to customers they'd traditionally shunned- subprime borrowers. These are borrowers with low credit ratings who pose a high risk of defaulting on their loan. But lenders reached out to get this type of borrower into homes. Then the no document loan was created, a type of loan for which the lender didn't ask for any information and the borrower didn't offer it. With the introduction of MBSs, lenders no longer assumed the risk of a loan default. They simply issued the loan and sold it to others who took the risk if payments stopped. And since MBSs created early on were based on mortgages granted to the more dependable prime borrowers, the securities performed well. They performed so well that investors clamored for more.

## What Are They?

Mortgage backed securities have come to be one of the biggest businesses in the secondary market for investors looking to pay a small amount that can be very lucrative in the future. The secondary market provides a way for lenders to sell a loan. It provides opportunities for investors to get into the real estate market without actually having to go through the process of buying property. What is a mortgage backed security? A mortgage backed security is a bunch of loans pooled together for investors, which are an asset backed security whose cash flow is a combination of principal and interest payments. Payments are made over the lifetime of the loan.

## Conclusion

The Federal Reserve will spend forty billion a month to buy mortgage backed securities for as long it is needed. With the Federal Reserve's buying of MBSs frees the cash banks have so they can issue out more loans to people who are in dire need. That's good also because that keeps the interest rates banks gives to its customers on loans low. The central intention is to give banks more assets, with the goal of inspiring them to loan out the money and spur more economic growth. In addition, the purchases are designed to push exceptionally low mortgage rates even lower which could potentially boost a flagging housing market.